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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1963.

No. 690

IN THE MATTER

*of*

PLYMOUTH DYEING CO., INC., a corporation of the State of New Jersey, Bankrupt.

P. A. C. REALTY COMPANY, ALFRED GELLENE, SR., ALFRED GELLENE, JR., CHARLES ROSENBERG and ALVIN L. ROSENBERG,

*Petitioners,*

*vs.*

DAVID E. FELDMAN, Trustee,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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# Supreme Court of the United States

OCTOBER TERM, 1963.

No. .....

P. A. C. REALTY COMPANY, ALFRED GELLENE, SR., ALFRED GELLENE, JR., CHARLES ROSENBERG and ALVIN L. ROSENBERG,

Petitioners,

*vs.*

DAVID E. FELDMAN, Trustee,

Respondent.

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

TO THE HONORABLE THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioners, P. A. C. Realty Company, Alfred Gellene, Sr., Alfred Gellene, Jr., Charles Rosenberg and Alvin L. Rosenberg, respectfully pray for the issuance of a Writ of Certiorari to review the final judgment of the United States Court of Appeals for the Third Circuit entered September 25, 1963.

### Opinions Below.

There is appended to the Petition for Certiorari the opinion of the United States Court of Appeals for the Third Circuit which is directly attacked on this application. It is officially reported at 323 F. 2d 134 (3d Cir. 1963).

Printed in the appendix filed herewith is the opinion of the Referee in Bankruptcy (R. 160a) and the opinion of the United States District Court for the District of New Jersey (R. 175a).

## Basis of Jurisdiction.

a. The date of the judgment sought to be reviewed is September 25, 1963. This is the judgment of the United States Court of Appeals for the Third Circuit duly entered on the foregoing date. The within application is made within 90 days of the entry of such judgment.

b. The jurisdiction of this court to issue the Writ of Certiorari herein prayed for is conferred by Title 28 U. S. C. §1254(1).

## Questions Presented.

1. Did the assertion of summary jurisdiction by the Referee in Bankruptcy deny petitioners the jury trial to which they were entitled?

2. Did the courts below misapply the standards heretofore set forth by the Supreme Court as determining the limited circumstances in which the Bankruptcy Court may determine in summary fashion the rights and liabilities of non-bankrupts subject to its jurisdiction?

3. Did the Referee fail to hold a proper preliminary hearing and did he in fact convert his hearing into a plenary hearing that he had no authority to conduct?

4. Bankrupt 9 years prior to bankruptcy transferred assets in exchange for stock of petitioner P. A. C. Realty Company which assumed some liabilities of bankrupt. Bankrupt distributed the P. A. C. stock to its stockholders. Bankrupt was solvent at the time and all creditors of the

bankrupt for 7 years thereafter were paid. Did petitioner P. A. C. have a substantial adverse claim so as to sustain its objection to the summary jurisdiction of the Bankruptcy Court to direct a turnover of petitioner P. A. C.'s assets to respondent, bankrupt's trustee?

5. Did the Bankruptcy Court hear and decide a case that should be properly heard only in a court that provides for trial by jury as guaranteed by the Seventh Amendment?

## Statutes Involved.

Attached hereto as Appendix A is Bankruptcy Act, §2(a)(7), 11 U. S. C. §11(a)(7) (1946), which recognizes the right of an adverse claimant to make timely objection to the jurisdiction of the Bankruptcy Court.

Attached hereto as Appendix B is Bankruptcy Act, §23(a), 11 U. S. C. §46(a) (1946), which maintains the distinction between proceedings under the Bankruptcy Act, and plenary proceedings, that is, "controversies at law and in equity, as distinguished from proceedings under this Act, between receivers and trustees as such and adverse claimants".

Attached hereto as Appendix C is Bankruptcy Act, §23(b), 11 U. S. C. §46(b) (1946), setting forth the courts in which the trustee may bring a plenary suit.

## Constitutional Provision.

AMENDMENT VII.

In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law.

## Statement of Facts.

(All references are to the appendix in the Court of Appeals for the Third Circuit, which appendix together with the supplemental appendix, was agreed to by all parties below as in effect a joint appendix. All references are to the original appendix—the supplemental appendix is not cited.)

The bankrupt originally engaged in the textile dyeing business in Paterson, New Jersey. Its officers, stockholders and directors were as follows:

Mr. Paul Manton, 50% of the stock
Mr. Alfred Gellene, Sr., 25% of the stock
Mr. Charles Rosenberg, 25% of the stock

The company prospered and realized substantial profits as follows:

| Year | Amount of Profit | Loss |
|---|---|---|
| 1943 | $ 33,774 | — |
| 1944 | 42,910 | — |
| 1945 | 61,959 | — |
| 1946 | 233,014 | — |
| 1947 | 491,934 | — |
| 1948 | 645,552 | — |
| 1949 | 405,553 | — |
| 1950 | 268,008 | — |
| 1951 | | $237,881 |
| 1952 | 12,801 | |
| Total | $2,195,585 | $237,881 (R. 97a, 98a). |

In 1952 Congress amended the Internal Revenue Act and enacted what is now Sec. 355, permitting a corporation to "spin off" assets and effect a non-taxable distribution to stockholders. To save substantial taxes and to take advantage of the new statute, acting under the advice of

counsel and accountants (R. 113a), P. A. C. was incorporated. Mr. Manton held 50% of the stock, Mr. Gellene 25% and Mr. Rosenberg 25%. To this corporation Plymouth "spun off" by deed, fixed assets of the value of $737,324 and Plymouth received in exchange all of the capital stock of P. A. C. In addition, P. A. C. assumed and paid certain liabilities of Plymouth amounting to $32,184 (R. 100a). The capital stock of P. A. C. had a value therefore of $705,140 (R. 100a) and was consideration for the transfer of the assets from Plymouth to P. A. C. Shortly thereafter, pursuant to the Internal Revenue Code and regulations thereunder, the shares of P. A. C. were distributed as a non-taxable distribution to Manton, Gellene and Rosenberg. This took place on or about June 20, 1952 and title to the assets transferred remained in P. A. C. from that date. June 20, 1952 is the critical date in this matter (R. 97a).

The financial condition of Plymouth as of May 31, 1952, the date of the nearest prepared balance sheet to the "spin off", was substantially the same on June 19, 1952, the date before the "spin off" (R. 98a). This balance sheet (Exhibit D-1, R. 158a) showed:

| | |
|---|---|
| Current Assets | $358,442 |
| Fixed Assets | $721,348 |

which with other assets brought the total assets to $1,119,642. Total liabilities were approximately $99,855 (R. 99a).

After the transfer to P. A. C. on June 20, 1952, the assets and liabilities of Plymouth remained the same since the shares of stock of P. A. C. were of the precise value of the assets transferred less the liabilities assumed—namely $705,140 (R. 100a).

After the non-taxable distribution of the P. A. C. stock to Messrs. Manton, Gellene and Rosenberg, both account-

ants agree that the ratio of Plymouth's assets to liabilities was 4.74 to 1 (R. 35a, 101a).

All the debts of the bankrupt company were paid for the years 1952, 1953 and 1954. In 1955, after operating for January and part of February, the officers of Plymouth decided to stop operating and the corporation, retaining its charter, did not operate for the next 10 months. It filed its income statement for the approximately 2 months of operation (R. 101a, 102a).

On February 23, 1955, 3 years after the "spin off", Mr. Manton, the holder of 50% of the stock of Plymouth and P. A. C., sold his interests in both companies to Messrs. Rosenberg and Gellene for $76,000. He resigned as an officer and director of the two corporations (R. 102a), and his stock was divided among the respective members of the families of Messrs. Gellene and Rosenberg. The sale by Mr. Manton of course constituted a substantial change in the personnel constituting the stockholders of the two corpofations.

As set forth above Plymouth ceased doing business in February, 1955. On February 17, 1955 a corporation was organized known as Hood Dye & Print Works to do textile dyeing. It did not begin operations until after March 17, 1955 when it changed its name to Plymouth Dyeing Co. and for the purposes of this petition we shall use the term Hood-Plymouth in discussing its activities to distinguish it from the old company. The stockholders of Hood-Plymouth were:

| | |
|---|---|
| Alvin Rosenberg | 99 shares |
| Louis Green (now dead) | 1 share |
| H. Leo Bohl | 50 shares |
| Alfred Gellene, Jr. | 50 shares |

Mr. Bohl, a member of the Bar of New Jersey, was president of the company. The investment of the stockholders

was $15,000. Mr. Rosenberg put up $7,500, Mr. Gellene $3,750 and Mr. H. Leo Bohl $3,750 (R. 113a). It commenced operations as a tenant of P. A. C. and continued to operate for about 9 months when it decided to liquidate.

The Referee stated in his opinion as follows:

> Early in 1955, the officers formed a new corporation called Hood Dye & Print Works, Inc. This corporation never actually operated under its corporate name, and a new corporation was formed about March 1st, 1955 with the name Plymouth Dyeing Company, Inc. (R. 163a).

While not crucial to the issue in this case, this statement is inaccurate, according to the uncontradicted testimony. The Referee failed to mention the new stockholders of Hood-Plymouth. Hood Dye & Print Works was formed by Mr. Bohl, Mr. Rosenberg, Mr. Gellene, Jr. and Mr. Green on February 17, 1955. It changed its name to Plymouth Dyeing Co., Inc., on March 10, 1955 and commenced operations April 13, 1955 as a separate entity (R. 105a, 106a). This corporation never continued the operations of the bankrupt company. It operated as an independent entity, with different stockholders from the bankrupt company, with its own set of books (R. 106a, 107a-110a) and its own income tax reports.

Hood-Plymouth stopped operations on or about December 30, 1956 and was dissolved and its stockholders received back their original investment. Plymouth Dye Works, the old company, was then reactivated. It took over the assets of Hood-Plymouth and assumed the liabilities of Hood-Plymouth (R. 108a). Plymouth Dye Works then changed its name to Plymouth Dyeing Co. and operated under that name from January 1, 1956 to April, 1961, when it was adjudicated bankrupt.

There was also introduced in evidence Exhibit D-6 (R. 159a) consisting of a list of creditors filed in the bankruptcy court. An analysis of the invoices attached to the proofs indicated no invoices antedating 1960. *Every creditor of Plymouth from 1952 to December 31, 1959 has been paid in full* (R. 101a-102a, 108a-109a).

Plymouth Dyeing Co. and P. A. C. had always filed separate income tax returns, had separate books of account, had their own Social Security accounts and each paid the premiums on its own respective insurance policies (R. 109a, 110a).

The trustee filed a petition in the Bankruptcy Court to extend the jurisdiction of the court over petitioner P. A. C. (R. 2a). Timely objection to the trustee's petition was made by petitioners (R. 6a) and the Referee held a two-day hearing. He rendered his opinion (R. 160a) and order granting the relief sought by the petition (R. 173a). An appeal was taken to the District Court, which affirmed (R. 175a, 176a), and a further appeal was taken to the United States Court of Appeals for the Third Circuit, which also affirmed.

## Argument.

### Preface.

This Court has in recent years given increasing protection to the right of every litigant to a jury trial in all cases in which he is entitled to such a trial. The Court has been especially vigilant to make certain that lower courts, both federal and state, have not, while giving lip service to the concept, deprived litigants of the substance of that right. The Court has made its concern clear in cases arising both under federal statutes and under diversity jurisdiction. See, *e.g.*, the numerous cases arising under the Federal

Employers' Liability Act and such cases as *Atlantic and Gulf Stevedores, Inc.* v. *Ellerman Lines, Ltd.*, 369 U. S. 355 (1962).

The present case arises under the Bankruptcy Act. As set forth below, p. 10, *infra*, that statute specifically contemplates a plenary proceeding between a trustee in bankruptcy and an adverse claimant where the latter makes timely objection to the summary jurisdiction of the Bankruptcy Court. Such a plenary proceeding would be in the nature of an action in replevin by the trustee—an action to recover property. It needs no citation of authority to state that in a federal court petitioners would be entitled to a jury trial under the Seventh Amendment in such a case. We need not raise the question whether the Fourteenth Amendment would require a jury trial in the state courts because in New Jersey, where such a trial would have to take place in this case (as the situs of the land and the domicile of the parties), the parties would have a constitutional right to trial by jury under the New Jersey Constitution. See Art. I, §9.

Interpreting the provisions of the Bankruptcy Act, this Court has repeatedly permitted the Bankruptcy Court to adjudicate disputes between trustees in bankruptcy and adverse claimants, but only where the "adverse claim is not substantial," or where it is "merely colorable". See cases cited at pages 14-15, *infra*. This is recognized as a highly unusual situation since a hearing before the Bankruptcy Court is quite a different judicial process from a plenary hearing with or without jury in a regular court.

Petitioner's contentions are threefold:

(1) It is the purpose of the Bankruptcy Act and this Court's decisions thereunder to assure an adverse claimant's right to a plenary hearing (and his right to jury trial) in all but those exceptional cases where the adverse claim is

frivolous. The decisions of the courts below have departed from this purpose and the effect will be to permit a considerably expanded power in the Bankruptcy Court to decide summarily cases between trustees in bankruptcy and adverse claimants.

(2) As a corollary to this contention it follows that the decision of the Court of Appeals permitting the referee to decide summarily a contest between a trustee and an adverse claimant not only deprives the latter of his right to a plenary hearing and jury trial in another court but also vests in the Bankruptcy Court a power that contravenes the Seventh Amendment directly.

(3) The referee also erred in the method he chose to decide the question of jurisdiction. Instead of holding a preliminary hearing, he held, without authority, a plenary hearing and having reached a decision on the merits, he decided that a decision in favor of the trustee gave him jurisdiction.

We shall now proceed to amplify these points.

## POINT I.

### The improper procedure used by the referee to determine if he had jurisdiction denied petitioners a plenary hearing in violation of the Bankruptcy Act.

The Bankruptcy Act has specifically granted to an adverse party the right to have his claim heard in a plenary proceeding. Section 2(a)(7), 11 U. S. C. §11(a)(7) (1946) recognizes the right of an adverse claimant to make timely objection to the summary jurisdiction of the Bankruptcy Court and thus to preserve his right to a plenary hearing. Interpreting this section, the Supreme Court has created a limited exception, permitting the Bankruptcy Court to hold

a preliminary hearing to determine whether the claim of adverseness is "merely colorable," *Harrison* v. *Chamberlin*, 271 U. S. 191, 194 (1926) (quoted at p. 14, *infra*), or "on its face made in bad faith without any legal justification." *Mau* v. *Henderson*, 268 U. S. 111, 119 (1925). Therefore if petitioners' claim was more than frivolous, they were entitled to be heard in a plenary hearing, not before the referee, but in a court where such a controversy could have been heard had not bankruptcy supervened. Bankruptcy Act, §23(b), 11 U. S. C. §46(b) (1946).

The sole question before the referee then was whether petitioners' claim was "frivolous." The first matter he had to determine was the method or procedure of determining this question. At this point he erred and this error governed the entire proceedings. The proceeding before the referee is merely a preliminary hearing, to determine whether the alleged adverse claimant is entitled to a plenary proceeding. If so, such claimant is entitled to have the trustee file a complaint in a court of competent jurisdiction and proceed as with a regular lawsuit, with the right to trial by jury.

The preliminary hearing is not for the purpose of being itself a full and plenary hearing. Yet a reading of the transcript will make it obvious that the hearing became in fact a full and complete hearing—to the surprise, it may be added, of at least the petitioners' attorneys.

While the transcript indicates that the paramount claim by the trustee was that of a fraudulent transfer by the bankrupt to petitioner P. N. C. Realty Company, the opinion went off on another ground and found jurisdiction on the ground of identity of interest. We submit that what happened here shows the wisdom of requiring only a preliminary hearing to determine jurisdiction; petitioners have in fact been denied the protection of a true plenary hearing

while being made subject to what amounted to a hearing on the merits without realizing it. What occurred is that the referee turned the preliminary hearing into a full hearing without the appropriate safeguards thereof and decided against the adverse claimant on the merits. We call attention to a most important footnote in the opinion of the Court of Appeals:

> Actually, the referee made an express finding that "both P. A. C. and Plymouth were solvent at the time of the 'spin off', and no fraud on creditors was then created." This has the appearance of a finding on the merits, when—in light of the referee's determination on this issue—the merits of trustee's allegation should not have been reached. (footnote 5, printed in full at pages 31-32, *infra*).

Thus on an issue which petitioners always considered crucial, the Court of Appeals recognized that a finding on the merits was made in petitioners' favor. But while the Court of Appeals stated that the referee should not have decided that question on the merits, it sanctioned such a decision on the so-called agency theory. In other words, where the petitioners prevailed, the referee should not have gone further, but where on the referee's view of the evidence the trustee prevailed, it was perfectly legitimate to direct a turnover summarily. We submit that the Court of Appeals itself fell into the same error for which it criticized the referee in this footnote. In fact, the footnote reveals that the referee was actually deciding everything on the merits. The Court of Appeals affirmed one such finding instead of limiting its review to the question of whether there was a justiciable issue before the referee. A reading of all the opinions below makes it clear that there was a bitter dispute both as to the facts and the applicable legal theory. The

identity theory, which all the courts below were forced to adopt as the theory for allowing an extension of the bankruptcy proceedings, is the most difficult in law to prove. Fraud is the usual basis for such an extension and on that issue the trustee clearly lost. Indeed, as was demonstrated in the briefs before the court below, all of the cases cited by the referee to sustain his position involved fraud.

This court has noted the distinction between summary hearings and plenary proceedings in *New Hampshire Fire Insurance Co.* v. *Scanlon*, 362 U. S. 404, 406 (1960):

> Summary trial of controversies over property and property rights is the exception in our method of administering justice. Supplementing the constitutional, statutory, and common-law requirements for the adjudication of cases or controversies, the Federal Rules of Civil Procedure, 28 U. S. C. A., provide the normal course for beginning, conducting, and determining controversies. . . . The very purpose of summary rather than plenary trials is to escape some or most of those trial procedures. Summary trials . . . may be conducted without formal pleadings, on short notice, without summons and complaints, generally on affidavits, and sometimes even *ex parte*. . . .

The *Scanlon* case was not a bankruptcy case, but the foregoing language and principle were specifically adopted in *Jackson* v. *Sports Company of Texas, Inc.*, 278 F. 2d 716 (5th Cir. 1960). In *Jackson*, the referee held a hearing to determine whether an adverse claim was real and substantial or merely colorable. The referee did exactly what was done by the referee in the instant case: he held a lengthy hearing, went into all the questions of fact and decided the merits. He too was affirmed by the district court. In reversing, the Court of Appeals said:

> We do not believe that the duty of the Referee to enter upon a preliminary inquiry to determine whether the adverse claim is real and substantial or merely colorable justified the extended hearing conducted here and the entry of an order adjudicating the claim of appellant on its merits. *Id.* at 718.

In *Jackson*, unlike the case at bar, the referee actually found fraud. The court held he had no right to do so.

> We think that whether the deed from the corporation to appellant was fraudulent and void under the complicated facts in the record should be determined by a plenary hearing on the merits. *Id.* at 716.

The Court of Appeals would not even consider the referee's findings:

> We express no opinion on the questions of fact decided by the Referee and approved by the court below, holding merely that they should have been submitted by plenary suit to a proper tribunal. *Id.* at 719.

The Fifth Circuit in *Jackson* relied for its holding on the landmark decision in *Harrison* v. *Chamberlin*, 271 U.S. 191, 194 (1926). There a unanimous Supreme Court held:

> It is well settled that a court of bankruptcy is without jurisdiction to adjudicate in a summary proceeding a controversy in reference to property held adversely to the bankrupt estate, without the consent of the adverse claimant; but resort must be had by the trustee to a plenary suit. (Citing cases) . . . However, the court is not ousted of its jurisdiction by the mere assertion of an adverse claim; but, having the power in the first instance to determine whether it has jurisdiction to proceed, the court may enter upon a preliminary inquiry to determine whether the adverse claim is real and substantial or

merely colorable. And if found to be merely colorable the court may then proceed to adjudicate the merits summarily; but if found to be real and substantial it must decline to determine the merits and dismiss the summary proceeding. (Citing cases)

In the present case the holding of the District Court that the adverse claim was merely colorable was evidently based upon its conclusion, upon the entire evidence, that the claim was fraudulent; and was, in effect, an adjudication upon the merits. And on the other hand, the holding of the Circuit Court of Appeals that the claim was of such a substantial character as to require its determination in a plenary suit, was based upon the view "that a claim alleged to be adverse is only colorably so when, admitting the facts to be as alleged by the claimant, there is, as matter of law, no adverseness in the claim". It is clear, however, that an actual claim may be adverse and substantial even though in fact "fraudulent and voidable." (Citing cases)

Then the court went on to say:

And, on the other hand, a claim is merely colorable if "on its face made in bad faith and without any legal justification." [Citing *May v. Henderson*, 268 U. S. 111, 119 (1925)].

This case is most important because it lays down rules for the guidance of bankruptcy courts.

(a) The referee may make a preliminary inquiry to to determine whether the claim is real and substantial or merely colorable;

(b) The court defined the term "colorable"— "if on its face made in bad faith and without any legal justification."

It should have been obvious to the referee at the outset that the claim was adverse and substantial. The question of

a fraudulent conveyance in 1952 was going to be hotly contested, especially as it was clear that the debtor was solvent both before and after the conveyance. Yet the referee proceeded to have a full formal trial. That the referee misunderstood his function is demonstrated by what occurred after the trustee "had completed his case." Petitioners moved to dismiss the trustee's petition on the ground that a plenary proceeding was called for in view of the evidence already adduced. Indeed, the trustee's own witness had demonstrated that the transfer was made while the corporation was solvent and that all creditors from the date of the transfer, 1952, to 1960 had been paid in full (R. 101a-102a, 108a-109a). While the proceeding up to this point had gone beyond the scope of a preliminary hearing, the examination and cross examination still demonstrated at the very least a bitterly contested issue between the parties. In denying the motion, the referee did so on the ground that the testimony had established "a prima facie case." This shows that the referee was thinking on the merits, for he stated:

> I will deny your motion, at the present time. The Court has heard testimony which would indicate such a course of dealings between the parties, such as payment ostensibly for rent which was actually in excess of the contractual amount of the rent payments, payments for salary ostensibly when one of the witnesses of P. A. C. indicated he had no business relationship with the Plymouth Dyeing Company, the testimony of the accountant which indicates continuity of accounting procedures, the fact that the year of the spin-off there was this large deficit in operation, all those facts when linked together are sufficient in the Court's opinion to establish a prima facie case. Your motion will be denied (R. 95a).

His only consideration should have been whether petitioners' claim to be an adverse claimant was merely colorable.

Instead, he went on and forced P. A. C. to put in its case on the merits, with the result that he then decided the entire case on the merits.

## POINT II.

**The decision of the Court of Appeals is contrary to applicable decisions of this Court.**

A reading of the Court of Appeals' opinion demonstrates that the court in effect reviewed the evidence and held that it was sufficient to sustain the referee's decision. Had this been a true hearing on the merits, such a procedure on review would undoubtedly have been correct. But the Court's sole duty was to determine whether there was enough evidence adduced by the petitioners to require a plenary hearing. Nowhere in the Court's opinion does the evidence produced by the petitioners appear. It is not our purpose to argue the case on the merits here, because it has no place in this proceeding. But we call to the Court's attention some of the evidence presented by the petitioners only to show that there was a genuine dispute which should have been resolved in a plenary hearing, not in the Bankruptcy Court. The referee stated that the parties did not maintain separate identities. He was in error for the record clearly disclosed that the parties did exactly that. Separate books were kept, separate income tax returns were filed, each carried its own insurance on its respective assets and each paid its own premiums. Each had its own Social Security account (R. 109a, 110a). It is not necessary to determine at this juncture whether or not the referee was correct in his findings regarding no separate entity; it is enough that there were facts before him to require that he not decide the matter. This is the

issue: not whether he decided wrongly, but whether he should have decided at all. The Court of Appeals reviewed the testimony at length, and also decided on the merits, instead of finding that there were issues of merit—on both sides, to be sure. Even the referee admitted in his opinion that the facts were "pro and con" (R. 162a).

In holding the claim of petitioners to be colorable only, the referee and the Court of Appeals dealt with the quality of testimony by a witness (R. 166a), alleged overpayment of rent by the bankrupt as a tenant (R. 162a), nominal salary payments and non-declaration of dividends (R. 164a) (Court of Appeals opinion: p. 29, *infra*). These go to the merits of the claim. The weighing of testimony particularly is error. See *In the Matter of Wire Corp.*, 131 F. Supp. 586, 588 (D. N. J. 1955).

This Court has always been alert to prevent bankruptcy courts, in their zest to enforce the provisions of the Bankruptcy Act, from infringing the rights, the constitutional rights, of nonbankrupt third parties to plenary hearings and jury trials. We have already cited and discussed *Harrison* v. *Chamberlin*, p. 14, *supra*. One of the more recent cases in this field is *Cline* v. *Kaplan*, 323 U. S. 97 (1944). In this case a petition in bankruptcy was filed September 22, 1941. The adjudication followed a month later. Assets of the bankrupt had come into the possession of the respondents 15 months prior to bankruptcy. The trustee filed a petition for a summary turnover.

The referee sustained an objection to summary jurisdiction, denying the turnover; he was reversed by the district court. The referee then decided against the trustee on the merits; he was again reversed. The Seventh Circuit reversed the district court and sustained the referee who had originally dismissed the trustee's petition for lack of jurisdiction.

The Supreme Court in a unanimous opinion reviewed the whole question of summary jurisdiction and affirmed the dismissal by the referee and the Seventh Circuit for lack of jurisdiction. In doing so the court said:

> Once it is established that the claim is not colorable nor frivolous, the claimant has the right to have the merits of his claim passed on in a plenary suit and not summarily. 323 U. S. at 99.

Can it be said that the claim of petitioner P. A. C. Realty Company is frivolous or colorable when the referee found that the bankrupt company and petitioner P. A. C. Realty Company were solvent in 1952, the date of the transaction, and that no fraud had been perpetrated on its creditors and that all creditors thereafter were paid through 1959?

Can the claim of P. A. C. be insubstantial when it gave all its capital stock, which had a value of $705,140, to Plymouth in exchange for the property conveyed and assumed and paid with its own funds $32,184 of Plymouth's obligations to Plymouth's creditors? (R. 100a)

If in the *Cline* case the Supreme Court sustained the objection to jurisdiction in connection with a transfer 15 months prior to bankruptcy, then this court should sustain defendants on the question of jurisdiction with respect to a transfer that took place 9 years prior to bankruptcy while both corporations were wholly solvent. (See also *Looschen Land and Building Co. v. Milson*, 266 Fed. 359 (3d Cir. 1920); in a case remarkably similar to the present case, the Court of Appeals reversed the referee and the District Court in an opinion that correctly states the applicable principles).

What the Court of Appeals has done in the present case is more than just to misapply the applicable principles enunciated by this Court. It has varied the law and in so doing it has expanded the jurisdiction of bankruptcy courts

beyond what was envisaged by the Bankruptcy Act. As was the case when certiorari was granted in the *Cline* case, the time has come for this Court once again to delineate, for the guidance of the lower federal courts, the limited extent of the bankruptcy courts' jurisdiction to decide contests between trustees and third parties summarily.

## POINT III.

**The decision of the Court of Appeals permitting the referee to decide summarily a contest between a trustee and an adverse claimant not only deprives the latter of his right to a plenary hearing and jury trial in a state or federal court but also vests in the bankruptcy court a power that contravenes the Seventh Amendment directly.**

This conclusion follows directly from our Point II. If we are correct that petitioners were entitled to a plenary hearing and jury trial in a state or federal court, then it follows that the referee had no authority to hold a hearing on the merits and decide the case. It requires no citation of authority to establish that an action to recover property from a third person, an action in the nature of replevin, was properly determinable by jury trial at the time the Seventh Amendment came into effect. That being so, this case could not be heard in the Bankruptcy Court, as there is no right to jury trial in that court. The holding of a hearing in that court is a direct violation of the Seventh Amendment.

This case shows how dangerous it can be to allow a "little" breach in the protections afforded by the Bill of Rights on grounds of convenience. Prior decisions of the Supreme Court have allowed the Bankruptcy Court to hold a preliminary hearing to determine whether a claim

was really "adverse." If the claim was found to be frivolous, the Bankruptcy Court could then decide the case summarily. The justification was the necessity for speedy resolution of questions regarding the property of bankrupts. Now even while purporting to follow applicable precedents, the Court of Appeals has pushed the exception so far that the Bankruptcy Court can decide serious contests between trustees and claimants. These hearings take place in an atmosphere that prejudices adverse claimants who have none of the protections afforded in a plenary proceeding and who are deprived of the fundamental right of trial by jury. Such is what happened in the present case.

## Conclusion.

The Court of Appeals for the Third Circuit has determined an important question of bankruptcy law contrary to decisions of this court. *Harrison* v. *Chamberlin*, 271 U. S. 191 (1926) provided the applicable procedure—a preliminary hearing to determine whether the adverse claim is real and substantial, and not a hearing of the entire case followed by an adjudication on the merits. That case rejects the idea that a full hearing can be held on the merits in the guise of a preliminary hearing and that a finding against the adverse claimant can confer jurisdiction so as to deprive him of a plenary hearing. But such a practice was approved by the Court of Appeals and if allowed to stand will permit referees to use summary turnover proceedings against adverse claimants irrespective of the fact that substantial dispute exists. The result arrived at here is clearly contrary to that envisaged by this court in *Cline* v. *Kaplan*, 323 U. S. 97 (1944), wherein it was held that a claimant with a claim neither frivolous or colorable was entitled to have his rights determined in a plenary suit and not summarily.

Certiorari should also be granted because the foregoing cases indicated that the Court of Appeals has sanctioned a departure from the usual course of proceedings to determine whether a bankruptcy court has summary jurisdiction. Such decision is not only a departure from the previous decision of the Court of Appeals for the Third Circuit in *Looschen Land and Building Co.* v. *Milson*, 266 Fed. 356 (3d Cir. 1920), but is contrary to the decision of the Court of Appeals for the Fifth Circuit in *Jackson* v. *Sports Company of Texas, Inc.*, 278 F. 2d 716 (5th Cir. 1960).

The present case is not merely one in which a court has misapplied the applicable law to a set of facts. When the principles enunciated by the Court of Appeals are viewed in the light of the facts of the case, it becomes apparent that the summary jurisdiction of the Bankruptcy Court has been significantly extended—at the expense of the rights of adverse claimants to a plenary hearing and a jury trial.

We are not dealing here with a matter of small importance. Comparable situations are presented in bankruptcy courts throughout the country every day, and we would predict that the bankruptcy courts will not be slow to appreciate the increased jurisdiction they can assume if this decision remains law.

Respectfully submitted,

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# APPENDIX A.

Bankruptcy Act 2(a)(7)

11 U. S. C. 11(a)(7):

"(a) The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy, and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this title, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—

"(7) Cause the estates of bankrupts to be collected, reduced to money, and distributed, and determine controversies in relation thereto, except as herein otherwise provided, and determine and liquidate all inchoate or vested interests of the bankrupt's spouse in the property of any estate whenever, under the applicable laws of the State, creditors are empowered to compel such spouse to accept a money satisfaction for such interest; *and where in a controversy arising in a proceeding under this title an adverse party does not interpose objection to the summary jurisdiction of the court of bankruptcy,* by answer or motion filed before the expiration of the time prescribed by law or rule of court or fixed or extended by order of court for the filing of an answer to the petition, motion or other pleading to which he is adverse, *he shall be deemed to have consented to such jurisdiction*;" (italics added)

## APPENDIX B.

Bankruptcy Act §23(a)

11 U. S. C. §46(a):

"(a) The United States district courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings under this title, between receivers and trustees as such and adverse claimants, concerning the property acquired or claimed by the receivers or trustees, in the same manner and to the same extent as though such proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants."

## APPENDIX C.

Bankruptcy Act §23(b)

11 U. S. C. §46(b):

"(b) Suits by the receiver and the trustee shall be brought or prosecuted only in the courts where the bankrupt might have brought or prosecuted them if proceedings under this title had not been instituted, unless by consent of the defendant, except as provided in Sections 96, 107, and 110 of this title. . . ."

# APPENDIX D.

## UNITED STATES COURT OF APPEALS.

FOR THE THIRD CIRCUIT

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Argued June 6, 1963

Before BIGGS, *Chief Judge*, and MCLAUGHLIN and GANEY, *Circuit Judges*.

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## Opinion of the Court.

(Filed September 25, 1963)

By MCLAUGHLIN, *Circuit Judge*.

This is an appeal from an order of the district court affirming an order of the referee in bankruptcy. The referee's order, issued in summary proceedings, extended the bankruptcy proceedings of Plymouth Dyeing Co., Inc. (Plymouth) to include the assets of P. A. C. Realty Company (P. A. C.). P. A. C. and its officers have at all times asserted their status as a substantial adverse claimant and have strenuously objected to the exercise of summary jurisdiction by the bankruptcy court.

The sole matter raised in this appeal is a question of jurisdiction: whether the issue below was properly tried in summary proceedings or whether the trustee should seek his remedy by way of plenary suit. More precisely, the question is whether the referee exceeded his jurisdiction in the process of his preliminary inquiry as to the character (colorable or substantial) of P. A. C.'s claim. We believe that the exercise of summary jurisdiction was warranted by the facts in this case.

The applicable principles of law are not in dispute. "A bankruptcy court has the power to adjudicate summarily rights and claims to property which is in the

actual or constructive possession of the court * * *. If the property is not in the court's possession and a third person asserts a *bona fide* claim adverse to the receiver or trustee in bankruptcy, he has the right to have the merits of his claim adjudicated 'in suits of the ordinary character with the rights and remedies incident thereto.' * * * But the mere assertion of an adverse claim does not oust a court of bankruptcy of its jurisdiction * * *. It has both the power and the duty to examine a claim adverse to the bankrupt estate to the extent of ascertaining whether the claim is ingenuous and substantial * * *. Once it is established that the claim is not colorable nor frivolous, the claimant has the right to have the merits of his claim passed on in a plenary suit and not summarily. Of such a claim the bankruptcy court cannot retain further jurisdiction unless the claimant consents to its adjudication in the bankruptcy court."[1] An adverse claim is said to be "substantial" "when the claimant's contention 'discloses a contested matter of right, involving some fair doubt and reasonable room for controversy' * * * in matters either of fact or law; and is not to be held merely colorable unless the preliminary inquiry shows that it is so unsubstantial and obviously insufficient, either in fact or law, as to be plainly without color of merit, and a mere pretense."[2] In applying the *Harrison* test to a particular set of facts "the referee must proceed to determine whether the adverse claim is 'plainly without color of merit and a mere pretense' *on a proper weighing of the testimony* considered in light of the claimant's self-interest and a due consideration of existing law." (Emphasis supplied).[3]

The undisputed facts disclosed by the referee's preliminary inquiry may be briefly summarized.

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[1] *White* v. *Kaplan*, 323 U. S. 97, 98-99 (1944). See generally, 2 Collier, Bankruptcy par. 23.01 (2)—23.07—pp. 452-530.

[2] *Harrison* v. *Chamberlin*, 271 U. S. 191, 195 (1926).

[3] *In re Merchman*, 105 F. 2d 995, 998 (2 Cir. 1939); *In re Gallin*, 115 F. 2d 626 (7 Cir. 1940), cert. denied, 312 U. S. 704 (1941); *Sahn* v. *Pagano*, 302 F. 2d 628, 630 (2 Cir. 1962).

In 1937 Plymouth Dye Works was formed by Paul Manton (50% interest), Alfred Gellene, Sr. (25%) and Charles Rosenberg (25%) to engage in the textile dyeing business. The corporation enjoyed substantial yearly profits until 1951 when it sustained a loss of $237,881. The following year appellant P. A. C. Realty was formed by Manton, Gellene and Rosenberg. The stockholders and officers of P. A. C. were identical with the stockholders and officers of Plymouth Dye Works. To this new corporation Plymouth Dye Works transferred its real estate, machinery and equipment and other minor items, with the exception of some office furniture and equipment. There is also testimony that P. A. C. additionally assumed and paid certain liabilities of Plymouth Dye Works amounting to $32,184. The net value of the transfer is placed at $705,140. In exchange therefor, Plymouth Dye Works received from P. A. C. all of its capital stock. This transfer of assets from Plymouth Dye Works to P. A. C. was carried out pursuant to the "spin off" provisions of the Internal Revenue Code.

Plymouth Dye Works then distributed all of the P. A. C. capital stock to its stockholders, Manton, Gellene and Rosenberg, who, as noted above, were also the stockholders of Plymouth Dye Works. Nothing was paid to Plymouth Dye Works for this distribution. The accountant for Plymouth Dye Works (and P. A. C.) testified that P. A. C. was formed at his suggestion in order to minimize Federal income taxes through utilization of the spin-off provisions of the Code. According to the testimony of Gellene, Sr. it was Manton's idea to form P. A. C. and he (Gellene) never asked why substantially all the fixed assets were to be transferred out of Plymouth Dye Works to P. A. C.

In any event, P. A. C. and Plymouth Dye Works thereafter entered into a written lease agreement on June 20, 1952 whereby P. A. C. leased the premises and machinery to Plymouth Dye Works for a term of one year. The lease, which was signed by Manton and attested to by Gellene,

Sr. as president and secretary, respectively, of both corporations, called for an annual rental of $42,000 payable in monthly installments of $3,500. For the six months period of June 20, 1952 to December 31, 1952 Plymouth Dye Works paid P. A. C. $36,000, or an overpayment of $15,000. In that year Plymouth Dye Works had a profit of $12,801. During the calendar year 1953 Plymouth Dye Works paid P. A. C. $72,000 for rent, an overpayment of $30,000, and in the same year had a loss of $79,041. In the calendar year 1954 the rental of $42,000 called for in the original lease was paid by Plymouth Dye Works, while it sustained a loss of $405,785.

On February 17, 1955 a new corporation known as Hood Dye and Print Works, Inc. was organized with stockholders of record consisting of Charles Rosenberg's son Alvin (99 shares); Alfred Gellene, Jr. (50 shares); Leo Bohl (attorney for Plymouth Dye Works—50 shares), and Louis Green (1 share). Its name was changed to Plymouth Dyeing Company, Inc. (hereinafter referred to as Hood-Plymouth) on March 10, 1955 and it commenced operation on April 13, 1955. The testimony indicates that the original 1937 corporation, Plymouth Dye Works, operated in January and part of February 1955 and then stopped doing business under that corporate name for the remainder of the year. Although the corporation, Plymouth Dye Works, did not continue business under that name after February 1955, the evidence revealed that there was a continuity of business function under the several corporate names throughout the year. Hood-Plymouth was dissolved on December 30, 1955 and Plymouth Dye Works was "reactivated" in order to take advantage of the loss carryback provisions of the Internal Revenue Code. Book entries were made transferring the assets and liabilities of Hood-Plymouth to Plymouth Dye Works and the latter then changed its name to Plymouth Dyeing Co., Inc. (Plymouth). Plymouth operated from January 1, 1956 until its present adjudication as bankrupt in April 1961.

In May 1955 a new written lease agreement was executed between P. A. C. and Plymouth, which provided for a six month term commencing April 15, 1955 with a rent of $18,000 plus 30% of the profit before taxes. In February of that year Gellene, Sr. and Charles Rosenberg had bought out Manton's interest in Plymouth Dye Works and P. A. C. for $76,000. Accordingly, the new P. A. C.-Plymouth lease was now signed by Gellene, Sr. and Rosenberg as president and secretary, respectively, of both corporations. In 1955 P. A. C. was paid $41,000 (or $41,200) as rent when only $38,000 was due under the applicable leases. Plymouth lost $81,640 in 1955. During the subsequent years Plymouth paid as rent $52,400 in 1956 (an excess payment of $16,400); $50,800 in 1957, $54,000 in 1958 and 1959 (an excess of $18,000 in both years) and $45,351 in 1960 (excess of $9,351). In the corresponding years Plymouth sustained losses of $24,281 in 1956, $12,526 in 1958, $115,546 in 1959, $219,844 in 1960 and had a $59,356 profit in 1957.

Although there was no written lease in existence between P. A. C. and Plymouth after 1955, P. A. C. does not dispute the accuracy of the above figures. P. A. C. alleges that the basic rental sums were provided for by oral leases agreed upon by the principals (Gellene, Sr. and Rosenberg) of Plymouth and P. A. C. No explanation is given for the payments in excess of either the written or oral leases. Thus, from June 20, 1952 to December 31, 1960 P. A. C. received a rental of $109,900 in excess of the total amount called for by the applicable leases. During this same period of excess rental payments Plymouth sustained a total loss of $577,352.

The testimony further showed that in the fall of 1960 P. A. C. issued a distraint on the remaining fixed assets held by Plymouth (primarily office furniture and equipment) for nonpayment of the September rent. These assets, having a cost value of approximately $18,000, were sold to P. A. C., but remained at the same premises and continued to be utilized solely by the tenant Plymouth. At

the time of the distraint Plymouth had a substantial bank account and subsequent to the sale it continued paying rent as before to P. A. C.

Against this background of the divestiture of tangible assets and the Plymouth-P. A. C. rental arrangements, additional undisputed facts appear. From 1952 to 1960 P. A. C.'s expenses of approximately $84,500 were attributable to taxes, insurance and repairs. The balance of the total rental payments—approximately $363,219—was spent for the acquisition of new equipment and fixed assets to be used by Plymouth in its dyeing operation. These rental payments were the sole source of income for P. A. C. P. A. C. shared the office space with Plymouth and had no separate designated office space of its own; P. A. C.'s books were kept by Plymouth's bookkeeper, her salary was paid by Plymouth; and P. A. C. never declared any dividends and at most paid its officers a nominal salary. The uncontradicted testimony of Gellene, Sr., one of the principals in both Plymouth and P. A. C., is especially illuminating. When asked what the sole function of P. A. C. was he replied, "We had no function, we just had real estate and machinery." And later he agreed that the sole function of P. A. C. was to collect rent from Plymouth. Gellene, Sr. characterized Plymouth as the "operating" corporation and referred to P. A. C. as "a realty company", although he acknowledged that P. A. C. was not in the real estate business. He "couldn't answer" and "didn't know why" the rent fluctuated from year to year.

P. A. C. factored the accounts receivable of Plymouth, never factored for any other concerns and did not solicit anyone else's business for the purpose of factoring. On this point Gellene, Sr. testified as follows: "Q. Why did [P. A. C.] have to factor [Plymouth]? A. We factored for it to be in business, instead of borrowing from someone else we thought we would factor ourself * * * Q. Whom do you mean by 'ourselves'? A. Well, Mr. Rosenberg and I. We advanced the [sic] P. A. C. and P. A. C. would advance it to the operating company."

A careful review of the transactions outlined above makes it clear that P. A. C. had no independent business existence and was organized for the sole purpose of serving and facilitating the business of Plymouth. The admission of Gellene, Sr., an officer and principal of P. A. C., that the corporation had no function other than to collect rent from Plymouth is especially persuasive. In essence, P. A. C. has nothing to support its claim to substantial adverse claimant status other than the existence of the corporate legal shell, separate federal income tax returns and separate insurance policies. Of course, the only source of P. A. C.'s income was the rental payments (and their excess) received from Plymouth. But "mere legal paraphernalia will not suffice to transform into a substantial adverse claimant a corporation whose affairs are so closely assimilated to the affairs of the dominant stockholder that, in substance, it is little more than his corporate pocket."[4] The facts adduced at the preliminary inquiry fully support the decision of the referee that there existed such an identity of interests between Plymouth and P. A. C. that P. A. C.'s claim could not be said to be substantial.

P. A. C. has continually placed great weight on the fact that at the time of the June 1952 spin-off Plymouth and P. A. C. were both solvent. It also stresses that every creditor of Plymouth and its nominal predecessors from 1952 to December 31, 1959 had been paid in full. While this is certainly relevant to the trustee's claim of fraud,[5] continued

[4] *Sampsell* v. *Imperial Paper & Color Corp.*, 313 U. S. 215, 218 (1941). In *Sampsell* there was also present an intent to defraud the creditors. However, it is clear that fraud does not have to be present in order to disregard the general rule of separate corporate identity. See, e.g., *In re Watertown Paper Co.*, 169 Fed. 252, 256 (2 Cir. 1909); but see *Maule Industries* v. *Gerstel*, 232 F. 2d 294, 297 (5 Cir. 1956).

[5] Trustee based his petition for extension of the bankruptcy proceedings over P. A. C. upon two independent grounds. He first presented the theory that the June 20, 1952 conveyance and transfer of all the real estate of Plymouth to P. A. C. was made with the intent to defraud the creditors of Plymouth by divesting Plymouth of all its physical assets. Further, he alleged that the transfer had the effect of causing Plymouth to become insolvent. Finally, the

emphasis on this fact tends to obscure the primary point of concern here, namely, the relationship between P. A. C. and Plymouth throughout this period. These latter facts demonstrate "without fair doubt and reasonable room for controversy," both as to fact and law that P. A. C.'s claim is colorable and that P. A. C. is merely an agent and instrumentality of the bankrupt. In that situation, we must conclude that the referee properly determined that the claim of P. A. C. is merely colorable and that, accordingly, it has not been deprived of its right to plenary trial. We find further that the referee, having correctly decided he had jurisdiction on that ground to proceed summarily, was not in error in his ruling that the assets of P. A. C. were

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transfer of P. A. C.'s capital stock to Gellene, Sr. and Rosenberg was said to be without consideration and fraudulent.

Trustee's second approach for recovery of P. A. C.'s assets was on the theory that P. A. C. was nothing more than an agent and instrumentality of Plymouth and accordingly the assets of P. A. C. were in the constructive possession of the bankrupt.

The referee's opinion states that the "trustee does not rely upon fraud" but rather upon his second theory that P. A. C. was the agent and alter ego of Plymouth. This is not quite accurate for the transcript of the hearings held before the referee reveals that trustee was proceeding at that time upon both theories alleged in his petition. Subsequently, in a letter memorandum to the referee after the close of the hearings trustee also states that he "has never abandoned his contention that fraud was actually intended and perpetrated in this matter * * *."

Actually, the referee made an express finding that "both P. A. C. and Plymouth were solvent at the time of the 'spin off', and no fraud on creditors was then created." This has the appearance of a finding on the merits, when—in light of the referee's determination on this issue—the merits of trustee's allegation should not have been reached.

Since the sole function of the preliminary inquiry is to ascertain whether the adverse claim is real and substantial or merely colorable, once the referee concluded that P. A. C.'s denial of fraudulent intent, etc. was substantial he should have gone no further on that point as he was "without jurisdiction" regarding it. If that had been the only theory presented by the trustee, he would have been forced to seek his remedy in a plenary suit. That problem becomes moot in the light of our view that the holding of the referee regarding the trustee's "agency" petition is thoroughly sound.

in the constructive possession of the bankruptcy court. And having justifiably found no need of taking further evidence on this latter question, the referee was wholly within his discretion in basing his ruling on the evidence adduced at the preliminary hearing.

The judgment of the district court will be affirmed.

A true Copy:

Teste:

*Clerk of the United States Court of Appeals for the Third Circuit.*